RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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MARCH 20, 1985 LETTER 909

March 8 DJIA 1269.66; PTI 1685; A-D Ratio -16.64
March 15 DJIA 1247.02; PTI 1673; A-D Ratio -17.18

THE MARKET: Probably the most important action in the stock market at this juncture is the relationship between the big blue chip leaders and the "rest of the market." This relationship is best expressed in the action of the D-J Industrial Average vs. the advance-decline ratio. The Dow represents the big blue chip leaders (the most visible part of the market), and the A-D ratio is a proxy of the rest of the market.

Note on the page 2 chart that the bulk of the market, as expresed by the A-D ratio, made its high on February 13 at minus 15.46 on the A-D ratio. On that same day the Dow recorded a high of 1297.92. A slight decline followed, and then a new rally. On the rally the Dow closed at another record high of 1299.36 (March 1), but as you can see on the chart the A-D failed to confirm. Then on March 7 the A-D ratio broke below its minor February 25 low point of minus 16.48 and the first downward zig-zag on the breadth index was formed.

The most important thing to watch for now is whether this divergence is compounded by perhaps a new unconfirmed high in the Dow. Or whether the market "pulls itself together" and both the Dow and the A-D ratio establish joint new highs (above the February 13 highs). As a rule, judging from years of past action, I note that it usually takes two non-confirmations on the part of price and breadth before serious decline gets underway.

A few other items are worth discussing at this time in relation to the apparent breakdown in the major averages and in the A-D ratio. The first is that volume has not expanded with lower prices. While this situation can change, a lack of volume when the averages violate preceding lows usually denotes an absence of real selling pressure.

Confirming this view is the low level of daily new lows on the NYSE. In fact, the worst my 5-day average of new lows has been able to muster on this decline is 13--hardly food for the bears.

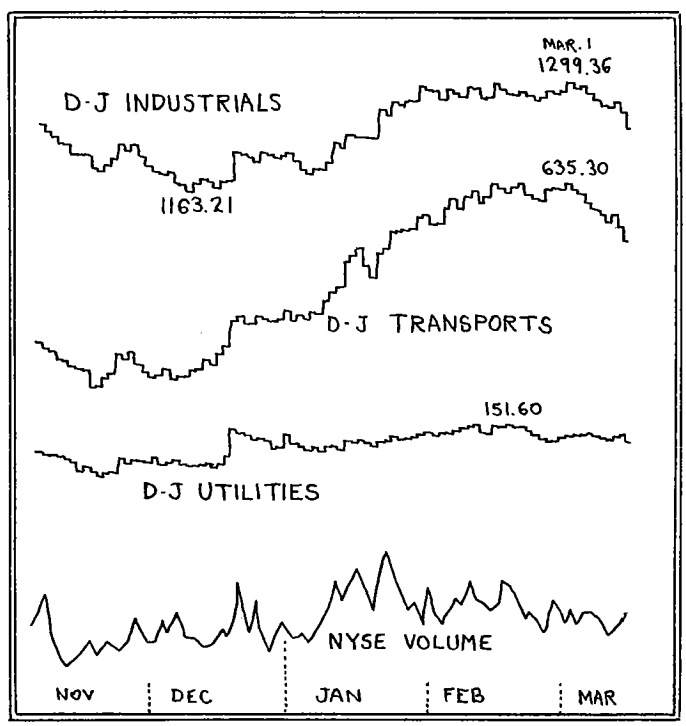
Another item to consider is this: the A-D ratio (a proxy for the entire NYSE) topped out on February 13. More than a month has now passed, and since then there have been a preponderance of declining days on the NYSE. But this action has not resulted in any severe damage to the market so far. A test of this is seen in the action of the short-term selling pressure index, which is simply a 10-day average of the daily decline. This index has pushed only minimally above the 10-day average of daily advances. Thus, a mild degree of selling pressure has been registered, but the significant fact is that selling has been so mild.

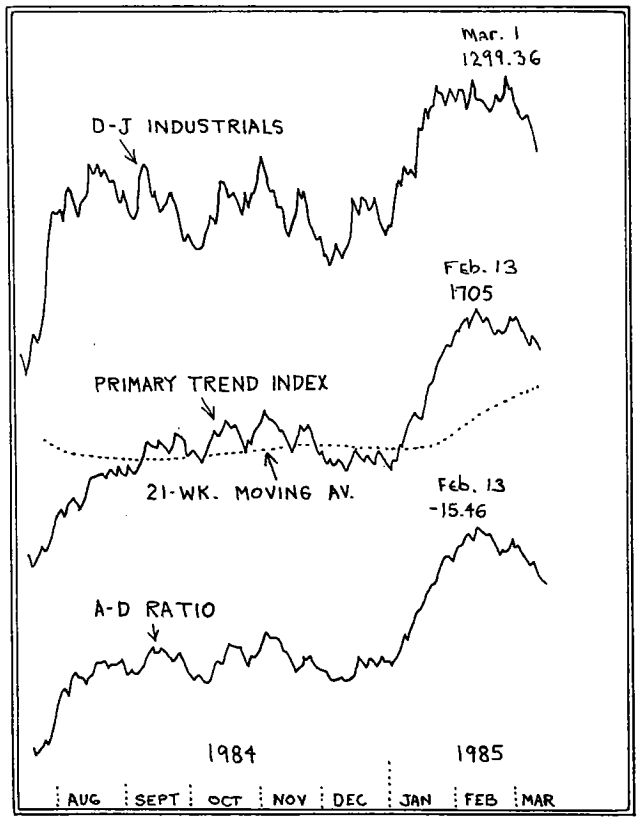
Referring to the page 2 chart, the Primary Trend Index (PTI) has now formed a downward zig-zag, but its rate of descent is mild, and the PTI is still well above its 21-week MA, I designate it as bullish (even though at this writing the minor trend of the PTI is down).

For new subscribers I might add that the PTI is based entirely on ACTION of the market type indicators (as opposed, for instance, to sentiment indicators or fundamental indicators). Thus the PTI measures the build-up or decline in the market's technical strength. Through long experience, my subscribers and I have learned not to be on the wrong side of the PTI. You can invest with it or stay out of the market--but you go against the action of the PTI at your peril.

Conclusion: The market went up too far and too fast. It is now correcting. The action of the A-D ratio is very important here. I believe that there is about a 50/50 chance that the A-D has seen its high for the year. If so, the stock market could be a rather frustrating place for traders for the remainder of 1985. For investors, I like the higher yielding blue chip stocks, stocks that have fat dividends under them and stocks with well covered dividends.

INVESTMENT POSITION: With the bull still in the box, I would hold all stocks and no-load funds. The Dow is still the stongest segment of the market, and on the thesis that strength is where you should be, I recommend holding the strongest Dow stocks. They are





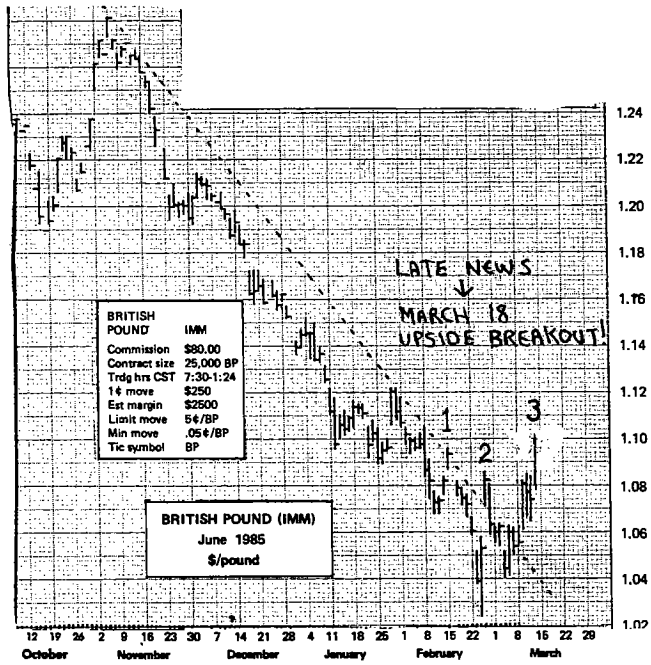
Amer. Brands, Amer. Telephone, Exxon, GE, Gen. Foods, United Technology, Westinghouse, Woolworth.

I'm more than a little bothered now that almost everybody is playing the "switch fund" game. When I first recommended the no-load funds, there was very little written about them or their switching capabilities. Don't ask me how or why, but when everybody starts playing the same game on Wall Street, the game is close to being over. I look for the no-load funds in general to underperform the Dow from here on.

I'm neutral on bonds now, but leaning towards a bearish opinion (since the T-bonds have now decisively broken important support). As for gold and the metals, I'm still leaving 'em alone (see page 6).

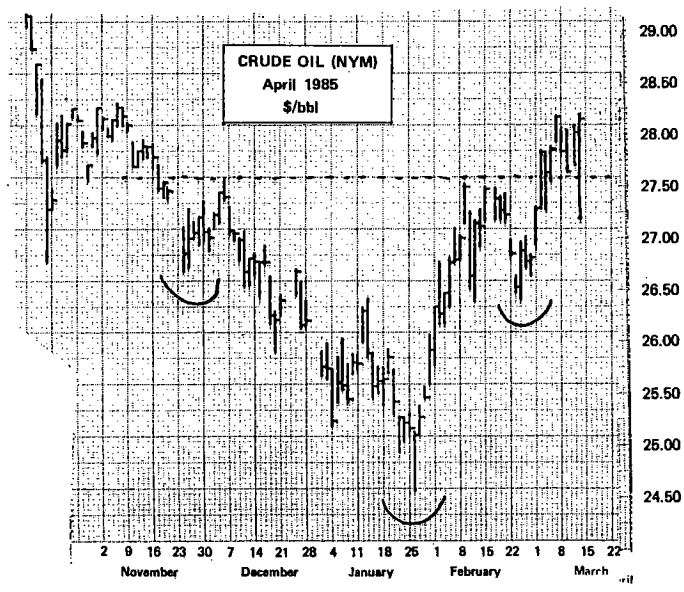
TURNS? Nothing is more fascinating (or profitable) than catching a major turn in the markets. As subscribers know, I have been watching in a number of places, and foremost is the dollar. This updated daily chart of the British pound (chart courtesy of Dunn & Hargitt) shows the late-February plunge of the pound and the rallies since. Note that at point 1 the pound attempted to reverse its steep downward trend--but the move failed. At point 2 a second attempt to reverse the downward trendline occurred, but this too failed--although this time the pound refused to drop to a new low.

Now for the first time the pound is at least fluctuating on the bullish side of the declining trendline. And the technical target is this--can the pound (June future) rally above point 1? It would take a move to 1.10 to do this, but if 1.10 is hit on a closing basis I would say that there is a better than

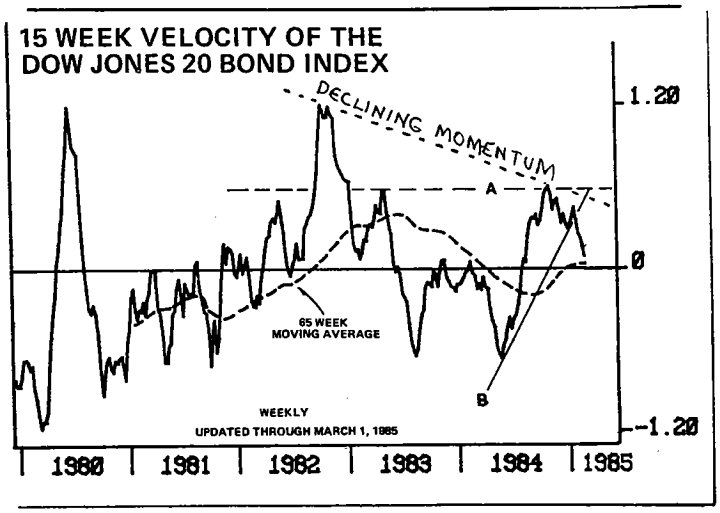


50/50 chance that we have seen a major top on the dollar.

Crude oil has now completed a head-and-shoulders bottom, and this is the second area of high interest for me. Technically a rise to 28.25 (April contract) would be a reconfirmation of the bullish trend in crude oil. Yes, I know that doesn't jibe with what you read in the newspapers, but the FACT is that oil has been hitting new highs for 1985. Match this chart with the statement by Charlie Maxwell as quoted in the last Letter.



I have been saying that the bond market has topped out. This chart shows the widely-followed D-J 20 Bond Average is in technical trouble. Momentum changes before price, and that is why this chart is so important. Here we see 20-Bond momentum breaking down and about to plunge below zero (on a 15-week rate-of-change basis). Chart is courtesy of Aden Analysis, 4425 W. Napoleon Ave., Metairie, LA 70001.



QUESTIONS & ANSWERS: Question: Russell, in your Feb. 21 Letter you recommended Fidelity Equity Income and Magellan funds as attractive no-load funds. Yet Equity has a 2% load and Magellan has a 3% load. Why call them no-loads?

Answer: Sorry, I was living in the past before these funds charged loads and before Fidelity got greedy. Neither fund is now a no-load fund.

Question: All during last year I read stories about the "new paper currency" that the Treasury was about to issue. What happened to the new currency?

Answer: The Treasury has so many more pressing problems that it has not had a chance to issue the new money. And most of the hard money boys have grown weary of writing about it. But the new paper will undoubtedly arrive some day. But it won't make any difference, except to those who are hoarding cash in their mattresses.

Question: I see the M-1 money supply is roaring at the rate of 12.8% for the period of mid-December to mid-February. Shouldn't this be visible via inflation very soon?

Answer: Inflation in the money supply can take anywhere from a year to two years to show up in actual inflation in the economy. Based on past data (see chart in Letter 905, page 4) we should be moving into a period of higher inflation now. But there are a few flies in the economic ointment. The first is the sky-high dollar. The dollar is making the US a picnic ground for foreign exporters, and "cheap" foreign exports are preventing many US manufacturers from raising prices.

Second, certain segments of the US (steel, electronics, agriculture) are slumping badly, and this has worked to hold back inflation. Finally, the massive debt structure hanging over the US is now sopping up probably $600 billion in interest annually. This is a very deflationary force and one that will not go away. Therefore, the old equation that states that higher money supply automatically means inflation may not work as before.

In studying the commodity charts I note that only one commodity, oil, can be listed as bullish. All the others from the metals to the grains to the woods and meats are bearish. Conceivably, we could be seeing the final washout of the commodities in this area, but I like to stick to the old adage, "What you see is what you get." Based on what I see in commodities, a new round of inflation has not yet started.

In all honesty, there seems to be two big exceptions to the no-inflation situation. The first is luxury items. The second is NYC Real estate. Forbes (Feb. 18) lists 13 super-luxury items from a Concorde round trip (Paris to New York), to a Rolex watch to a Broadway theatre ticket to a full length mink coat, and found an average jump of 8.2% in prices from 1983 to 1984. Of course, this study is already a bit dated.

I am including this chart showing real estate prices for farms and home prices in California and NYC. Note the unbelievable climb in NYC prices (although the climb in farm prices and California prices seems to be about over). New York prices are now in the stratosphere, and I am reminded of the old adage, "The bigger they come, the harder they fall." (Chart courtesy of Fraser Opinion, Box 494, Burlington, VT 05402).

	Farm Real Estate		Home Resale Prices			
			California		New York City	
	Price	Change				
1984	$739	-0.5%	$112,700	0.1%	$104,460	29.2%
1983	743	-5.8	112,590	2.3	80,850	3.1
1982	789	-0.8	110,020	3.8	78,400	14.8
1981	795	9.7	106,040	8.2	68,270	51.4
1980	725	15.4	98,040	18.3	45,100	48.9
1979	628	18.3	82,880	18.7	30,280	63.3
1978	531	12.0	69,800	13.8	18,540	44.7
1977	474	19.4	61,360	28.1	12,810	n.a.
1976	397	n.a.	47,910	n.a.	n.a.	n.a.

Question: Russell, I see that the Senate leaders are having a very tough time getting anything done on the deficit. And now it looks like they will need cuts of $60 billion and up to hit their target. What if they don't succeed in getting the cuts they want. What will Volcker do as the Treasury financing needs take off into the wild blue yonder (some economists are estimating a deficit of as much as $240 billion for 1986)?

Answer: This is a fascinating question. A lot of people don't like Volcker but nobody accuses the Fed Chairman of being stupid. Volcker has spent the last four years fighting inflation. He's taken a stand on inflation. If the Fed has to monetize a huge portion of the coming deficits, we are going to see super-monetary inflation. In fact, we're seeing some of that now, even though the actual inflationary results are being masked by the strong dollar and the wave of cheap imports.

Volcker has warned repeatedly that the deficit must be cut. If they it is not cut, I believe Volcker will allow interest rates to have their way. In that case, I think we will see the rates go through the roof--possibly to new record highs. Volcker would be in the clear. He could say, "Look, I warned, and I pleaded. Nothing got done. The markets are now doing the talking. The Fed did all it could."

Question: In recent Letters you have quoted S. Jay and David Levy ("Industry Forecasts" of Chappaqua, NY) to the effect that a severe profit collapse was coming in 1985 with corporate profits dropping as much as 40% on a year to year basis. In view of the current situation, do the Levys still stick to their forecast?

Answer: They do. The Levys continue to see big trouble for profits via the balance-of-payments disaster and a run-down of inventories. Because of the Levys' superb record over the years, I never ignore their opinions--the more so since their opinions

are now so contrary to the general consensus at this time.

Question: In the past you have written about very popular forecasters, and how a huge following for forecasters almost always seems to lead to trouble. How does this relate today?

Answer: With absolutely no desire to criticize or cast aspersions on the various advisors, it is remarkable how a large following invariably leads to trouble. The market, in its perversity, seems to pick the moment when the current "reigning Wall Street king" gains his peak of popularity — to doublecross him. Don't ask why or how it happens that way. It just does (I have made whopping mistakes myself, and I've never even been a reigning king).

Frankly, this study has always fascinated me, and I will recite a little more Wall Street history. (1) George Schaefer was a hero of mine and a genius at market forecasting. He was right on the major trend of the market for literally decades. Schaefer was also a great teacher, and I avidly followed his writings. By the early 1970's Schaefer had attracted a huge following with well over 10,000 subscribers. Then in 1974 Schaefer got caught in the early gold stock crash. Schaefer became confused and depressed and committed suicide in that year.

(2) Jim Dines was and is a brilliant advisor. Dines called the tidal bull move in gold all through the 1960's and 70's. Magazines and newspapers featured his advice and comments. But Dines rode gold over the peak and down. Had Dines moved his big following out of gold in late-1979 he would have made Wall Street's Hall of Fame.

(3) Joe Granville rode the great bear market all the way down during 1973-74. But at the 1974 bottom his fortunes changed. From 1974 on, Joe called every turn in the market with unbelievable success. Then he missed the mighty 1982-84 rise, and the genius mantel tumbled from his shoulders.

(4) The delightful Aden sisters burst upon the gold scene a few years ago when they called for multi-thousand dollar gold during the mid to late-1980's. Alas, despite great publicity and an adoring following, gold sank and sank and sank. Finally, the Adens conceded that the trend of gold was bearish.

(5) Dr. Henry Kaufman of Salomon Bros. had a huge following in the bond market. During 1984 and '85 his power became prodigious, and he was quoted in the newspapers almost daily. On May 4, 1984 Kaufman made one of his most dramatic and most acclaimed predictions. He said interest rates would be "spectacularly higher" in 1985. Rates hit a peak a month later--then collapsed during late-1984 and into early 1985. Those who had shorted bonds were destroyed. The Kaufman magic turned to dross.

All of these people were very bright. All developed a large following and were written up in national publications. Many graced the covers of national magazines. Yet none could stave off the ultimate "bad call." Ironically, in almost every case the bad call came at the height of their popularity.

Who is today's reigning advisory king, and what is he saying? In my opinion, today's success story is Robert Prechter of Elliott Wave fame. Bob is a favorite of mine, he is brilliant, and he is humble. And he has been very right. Bob is well aware of the danger of being a Wall Street folk hero and having a wide audience. But (fortunately or unfortunately) today Bob has both.

Prechter (via Elliott) is saying that we are now in Wave V of the massive bull market that has held Wall Street in its grip ever since since 1932. And Bob may well be right (and, of course, for his sake and ours, I HOPE he is right). But I keep thinking of "the curse of the leader" on Wall Street. And I wonder how it will all work out.

If history repeats, Prechter will look increasingly right until he has gathered his peak following. Then the gods of Wall Street will turn against him. Or maybe this time it will be different. Maybe Robert will beat the "curse of the big following" and come out on top. I've never, in forty years of watching markets, seen it done. But there's always a first time.

In closing this section, let me say that I personally admire all the people I have mentioned in this section. George Schaefer was, in fact, my greatest teacher. But Wall Street is my teacher, too. And it has told me, "nobody beats the market." They may beat it for a year, five years or a decade, but sooner or later we all make mistakes. And sometimes those mistakes can be whoppers.

Question: Russell, I know you believe that the current situation could lead to hyper-inflation or deep deflation. But how could we deflate if the Fed decides to take a big stand against deflation?

Answer: I have been debating this question for years. For instance, in his latest report Howard Ruff states, "Neither Paul Volcker nor anyone else will fight inflation at all costs, if those costs include a crash and a depression. We might get a depression by accident or stupidity but never on purpose."

Here is my thought: If the primary trend turns down and deflation envelopes the world, no Fed or Treasury or president will be able to reverse that trend. Consider this: gold makes up a portion of almost every central bank's reserves. Gold has already dropped 66% from its high of 1980. Do you think the central banks wanted to see their reserves shrink in value? Do you think the central banks of the world wouldn't have arrested the fall of gold if they could have? If the central banks can't even halt the fall of gold, how could they possibly halt the onslaughts of world deflation?

The primary trend of the market is stronger than any man, government or group of governments. If the primary trend of inflation did indeed turn down in 1980 (when gold topped out), then no force on earth is going to reverse it at will. And that, in a nutshell, is what worries me. It also worries me that the market has a perverse habit of doing whatever will drive the greatest number of people up the wall. Believe me, at this point almost no one is positioned for real deflation. The fact that the American public's assets are mostly tied up in illiquid real estate attests to this statement.

Question: In the last Letter (and in many previous Letters) you have mentioned Warren Buffet and his

great investing record. I note that Buffet uses fundamentals rather than timing. What do you think of this?

Answer: I think that the technical approach is now far too popular. In 1949, nobody used the technical approach. Now everybody uses it. But the great investment records (as Buffet points out in Barron's) have been made by the men who bought great values and then held those values for years. Thus, I think there is now a swing back to fundamental and value investing.

There is only one danger in ignoring technicals. Eventually, we will see a bear market which will, in its sweep, take everything with it. When that happens, the value investors will get crucified along with everyone else. Buying and holding great values works 95% of the time. Except those rare instances (like 1929, 1937, 1974) when good stocks get smashed below known values.

UNUSUAL STOCK: Petroleum & Resources is a $230 million closed-end fund. The fund holds mainly energy stocks, oil, natural gas producers and distributors and oil service firms. Income from investments is about $13 million. Ahead of all this (there are NO bonds) is an issue of 2 million convertible preferred shares. The preferred is convertible into common at the rate of one share of preferred into .458 shares of common (the common is now 25 but has been over 50 in the past). Both common and preferred trade on the NYSE.

The dividend on the preferred is $1.58 which means that it requires $3.1 million a year to cover the preferred dividend. With $13 million coming in, the preferred is VERY well covered. At a current price of 15, the preferred offers a yield of 10.5%.

If deflation arrives, the preferred of PEO should hold up well, due to the well-covered $1.58 dividend. If inflation roars again, the preferred would be a good hedge since it is convertible into the common which is loaded with oil and gas equities (all of which are now pretty much deflated).

This is a little known stock which could be interesting for the long pull. At worst, if the stock does nothing, the buyers sit with a 10.5% well-covered yield.

NOTES & QUOTES: Debt: Why worry about the long run, because (as Keynes stated, "In the long run we're all dead." Maybe so, but I have kids from ages 4 to 28 (five of them) and in the longer run they'll still be alive. So I tend to worry about the long run. And so does Ashby Bladen in the March 25 issue of Forbes. Bladen notes that the growth rate of M-1 last year was 5.2%. Which is fine, but he also notes that total debts outstanding rose 14%. He also notes that the actual dollar amount of debt here rose $800 to 900 billions, 2½ times the rate of GNP growth.

These statistics show that we could either have high inflation or a disaster as the rising debt structure sinks our ability to keep it afloat. Under these circumstances, Bladen offers a good-news-bad news item: The good news is "that there will almost certainly never be another deliberate credit crunch in the US this side of disaster. The bad news is that sooner or later a disaster, for all practical purposes, is ineveitable."

* *

REDS: With Mikhail Gorbachev now leading the Soviets, the enormity of his job becomes visible. A fascinating article in the March 15 New York Times provides a glimpse into the ghastly miasma which is now the Soviet economy.

The task is a daunting one, as any Western visitor to the Soviet Union quickly sees. Long lines form for consumer goods that would be scorned in Western shops. By American standards, the telephone service is rudimentary, banking is all but unknown, roads are few and poor, offices are ill equipped and officials inaccessible.

The centralized pricing system is so askew that meat costing the state $4 a pound to produce sells for 80 cents a pound. Spare parts are all but impossible to find; pricing policy is that spare parts must cost the same as parts actually installed in manufactured equipment, making it entirely uneconomical to maintain stocks around the country.

Inefficiency is glaring, as are absenteeism, drunkenness and sloth. When contracting with Western suppliers to bring in heavy machinery, the Russians have taken to having Westerners build the housing, too, so the expensive imports would not rust in the open while Soviet workers got around to finishing enclosures.

An Austrian company that built a steel mill near Zhlobin in Byelorussia brought in Yugoslav and Austrian laborers, and built everything down to barracks for the workers.

The problems are no longer an official secret in the Soviet Union. Newspapers are filled daily with stories of corruption, inefficiency, incompetence and mismanagement. Prominent economists openly debate measures to revive economic growth.

"Their real problem is the system of central control," said one senior Western diplomat in Moscow. "The economy cannot respond to changing conditions or advantages except by going through an enormous bureaucracy. The system is deadening to innovation, initiative. They simply don't have a mechanism that can run itself — it is one they must continuously prime."

Flagging Economy

According to Western statistics, the average annual growth rate of the Soviet economy has fallen to about 2 percent in recent years, from a peak of 5.2 percent in 1966-1970. Soviet living standards have fallen to about one-third of American standards, according to Western statistics.

And a huge dilemma faces Russia. China has now moved towards "people's capitalism" under its progressive leader, Deng Xiaoping. You doubt that the Soviets are worried? Read this item from the March 7 Christian Science Monitor.

One quarter of the world's work force is now moving into the twentieth century. Yes, I'm talking about the Chinese. And the thought: the average US wage is roughly $30 to $40 a day. Average Chinese wage -- a bit over $2 a day. Could be real competition coming up!

"The Chinese economy will be three times greater than that of the Soviet Union by the end of this century if both keep growing as they have in this decade.

By then, assuming a similar rate of population growth in both countries, the living standards of China's 1 billion people would be about 82 percent of that of the Soviet Union's 272 million people. That compares with about one-third now.

'There can be little question that we are witnessing a remarkable change in the world,' says consulting economist Sam Nakagama. 'China is now beginning to show growth rates similar to those of Japan in the 1960s and of such countries as South Korea, Taiwan, Hong Kong, and Singapore in the 1970s.'

'It must make (the leaders of the Soviet Union)

nervous,' notes Abram T. Bergson, a Harvard economics professor."

(from the Christian Science Monitor)

* *

Strategic Defense: The so-called "debate" goes on regarding the anti-ballistic missile defense concept known as the Strategic Defense Initiative. But the debate is a farce. The SDI is already in place, the new SDI already has status equal to the Army, the Navy or the Marines and the budget for the SDI is in place. This is the real reason why Reagan stated that the SDI is "not negotiable." Nine laboratories are now engaged in SDI research, and the research cost is $1.4 billion this year and going to roughly $3.7 billion (at Reagan's request) next year. Those who are still debating the program might study the following from a Feb. 19 NY Times piece:

WASHINGTON, Feb. 19 (AP) — In 1987, two years earlier than planned, the Pentagon will use the space shuttle to begin testing some of the technology that would be needed for a space-based missile defense system, a spokesman said today.

The initial tests will involve possible ways of tracking and targeting enemy missiles from a platform in space, said the spokesman, Michael I. Burch.

Lieut. Gen. James A. Abrahamson, the head of the antimissile research program, known as the Strategic Defense Initiative, has determined that "things are going along quite well," Mr. Burch said, "and feels that portion of the research program can be accelerated."

* *

Moving: Six of the 10 largest cities in the nation are in the American Southwest. One of them is San Diego, now the nation's eighth largest city (and a city with the world's best climate). San Diego is now a world center for biological and electronic research. And, at last, it is developing a downtown center. Some 86 major building projects worth $3 billion are now in progress downtown. Horton Plaza, a city in itself (11½ acres), will open this summer. For years, San Diego was a climatic paradise known only for its world-class zoo and the Navy (it's Pacific Fleet Headquarters). No more. San Diego is fast becoming a colossus and a cultural center (there are 50 dramatic theaters now functioning here). Oh yes, please stay where you are. We're also getting crowded here.

* *

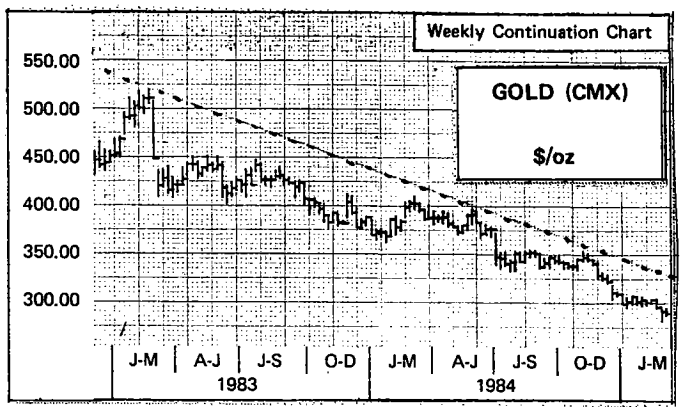
Have you heard the news about home computers? The news is nobody knows what the devil to do with them. Result: look for a big shakeout over the next year in the home computer business.

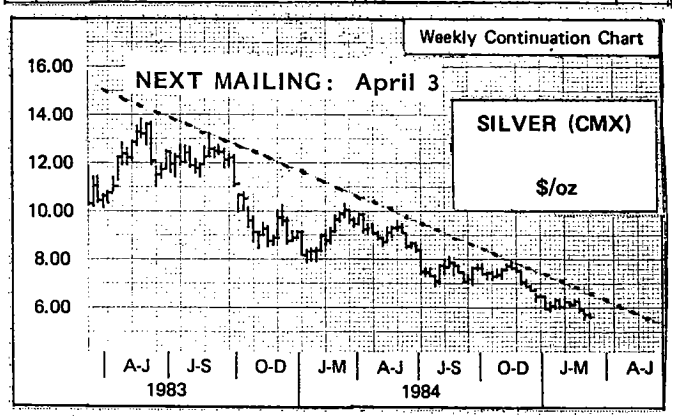
METALS: Sooner or later the "hard money boys" have to face it. Sentiment in the US and the world has changed. With interest rates remaining high, with inflation (for whatever reasons) staying low, the emphasis among investors is for INCOME. How do you retain (or try to retain) your standard of living? With INCOME! Therefore, I have said and I will repeat, the operative word for the rest of the 1980's is going to be income. As debt rises, and the government pulls back in its spending, as last year's luxuries become this year's memories, there is going to be an increasing push to try to retain "the good life " You do that with interest and dividends--not in the vault. And that's the reason my gold/common stock ratio has been sliding for the past six years (to last week's new low). The reason is that money is going out of hard assets that offer no return (and actually, they offer losses as inflation withers) and into financial assets--bonds, stocks.

Furthermore, if the new tax law passes (and I give it a good chance) the drop in high income tax brackets will make financial assets that much more attractive. With a ceiling of perhaps 35% on income taxes, there will be more incentive than ever to switch out of hard assets in favor of compounding your money in stocks or bonds.

In the meantime, the accompanying charts (courtesy Dunn & Hargitt) tell a simple but discouraging story for metal-philes. The trend for both gold and silver remains bearish. In fact last week, new future contract lows were set for silver and bellwether palladium. On the New York Futures Exchange the members wear little badges which state , "The trend is your friend." Those of us who have avoided the metals since 1980 know the fortune-saving truth of that statement.

But all things are subject to change, and somewhere ahead, some day, the metals will rise again. What would be the first hint of a turn? Spot gold at around 315 would have me studying the situation with renewed interest.





LATE NOTES: Following the buying stampede (a stampede which ended February 13) the A-D ratio has been down on 17 out of 21 trading sessions. Thus, the market is correcting for the euphoria of early 1985. I have never seen a market smash only one month after a buying stampede. But anything can happen on Wall Street. At present the PTI is still 25 points above its critical 21-week moving average. Daily new lows on the NYSE continue to be minimal and I will be watching those new lows carefully. Note: Re-read "Thoughts", page 3 of the last Letter.